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## THESIS

AN EVALUATION OF INTERNAL CONTROL FOR A  
NONAPPROPRIATED FUND INSTRUMENTALITY (NAFI)

by

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March , 1992

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An Evaluation of Internal Control for a Nonappropriated  
Fund Instrumentality (NAFI)

by

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## ABSTRACT

This thesis reviews the internal controls of selected transaction cycles for a Nonappropriated Fund Instrumentality (NAFI). A review of the Governments internal control requirements is followed by the review which utilized interviews, observation, and investigative techniques to gain an understanding of the internal control structure. The study includes narrative descriptions, transaction flowcharts, and internal control questionnaires for gaining full understanding of the business activities. Test of controls utilizing attribute sampling were employed to evaluate the effectiveness of the NAFI internal control structure. Analyses and recommendations are offered for improvement of internal controls.

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## I. INTRODUCTION

### A. BACKGROUND

The Nonappropriated Fund Instrumentality (NAFI) is a tool of the Department of Defense (DOD) and the individual services. It is designed to provide an essential function in support of the Morale, Welfare and Recreation (MWR) needs of military personnel, civilian employees, reservists, retirees, eligible family members, and other authorized users.

[Ref. 1:p. 18]

NAFI's are classified in accordance with a standard DOD classification system. The designator of the NAFI in this study falls into category D, which contains business activities that are highly desirable for providing recreational activity but are less essential to the overall military mission. [Ref. 1:p. 11]

Category D NAFI's are required to be self-supporting and generate funds through operations to support the MWR programs required and desired by the base on which they are located. The NAFI's are to operate in the most profitable manner possible to generate excess funds for subsidizing unprofitable MWR activities. Subsidizing is permissible when the activities are deemed highly desirable by the base commander



and can be adequately funded through the excess funds of other profitable MWR activities. [Ref. 1:p. 13]

The NAFI which is the subject of this study is the Golf Course Pro Shop and Dining Facility located at Fort Ord, California.

## **B. PURPOSE AND OBJECTIVES OF THE RESEARCH**

The mandate that NAFI's be self-sufficient where possible requires that each category D business activity be operated in the most efficient manner feasible. Efficiency allows base commanders to provide additional MWR activities to assigned personnel from the excess funds generated by profitable NAFI's. To ensure the efficient operation of each NAFI, the use of internal controls is required. The statutory requirements for the implementation and establishment of internal control systems extends from the Federal Manager's Financial Integrity Act (Public Law 97-255) to Office of Management and Budget (OMB) Circular A-123. [Ref. 2:p. 4]

The purpose and objective of this thesis is threefold: first, to determine the internal control requirements mandated by higher authority for the NAFI; second, to evaluate the internal controls presently in effect within the NAFI structure; and, finally, to determine the extent to which management controls meet the requirements of internal control criteria and are effective in preventing and detecting unauthorized procedures and errors.

### **C. SCOPE OF RESEARCH**

The thesis is limited in scope to those activities and functions which are performed locally at the Ft. Ord Golf Course Pro Shop and Dining Facility. The critical areas of research are those which present the greatest risk of material loss to the financial operation of the NAFI. Specific cycles which are germane to this study are the receipt and control of cash, the receipt and control of merchandise and inventory, and the administration of the payroll function. The majority of accounting functions are performed by a Central Accounting Office (CAO) which is geographically separated from the NAFI; therefore, these functions are not the subject of this thesis. Those accounting and record keeping functions which are under local control have been examined as they pertain to the critical areas in this study.

The scope is limited to those aspects of the business operation which are under direct control of local NAFI management personnel.

### **D. METHODOLOGY OF RESEARCH**

The study began with an identification of the internal control requirements that are mandated for the NAFI by higher authority. This was achieved by reviewing appropriate literature and documentation including Army Regulations,

Department of Defense (DOD) Directives, Department of the Army Pamphlets, and locally prepared regulations and organizational documents.

The next step was to obtain an understanding of the internal controls which were present at the NAFI. To achieve this objective, three investigative tools were employed. Control questionnaires were developed from sources which delineated internal control and operating requirements for the NAFI. Discussions with personnel and observance of daily and routine operations were conducted to increase knowledge and understanding of existing procedures. Finally, the critical operations were flowcharted to give a graphic display of transaction steps.

The final step was to test the controls in place at the NAFI and make an evaluation as to the efficiency and effectiveness of the implemented system. Attribute sampling and tests of controls were used to test the effectiveness of the internal controls in preventing and detecting unauthorized procedures and/or loss of NAFI assets.

#### **E. THESIS ORGANIZATION**

The thesis is organized in sequential steps as outlined in the following paragraphs.

Chapter II discusses the background of internal controls, their purpose, use, and mandate for implementation within the government and in particular the NAFI.

Chapter III provides the steps to obtaining an understanding of internal controls and depicts that understanding through presentation of narrative descriptions, flowcharts, and internal control questionnaires.

Chapter IV discusses the evaluation of the internal control system for the NAFI. This section includes tests of controls and attribute sampling used to arrive at the effectiveness of the internal control structure as implemented by the NAFI.

Chapter V analyses the data and findings and offers recommendations for the improvement of internal controls within the NAFI.

## II. INTERNAL CONTROLS OVERVIEW

### A. INTRODUCTION

The Accounting and Auditing Act of 1950 established the requirement for Government agencies to institute and maintain adequate systems of internal control. However, to combat continuous reported instances of fraud, waste, and abuse of Government resources, the Office of Management and Budget (OMB) Circular A-123 was issued in October 1981. This expounded internal control objectives and standards in an effort to strengthen and eliminate weaknesses within the internal control system of the Government agencies.

[Ref. 3:p. 1]

The Accounting and Auditing Act of 1950 was later amended by the Federal Manager's Financial Integrity Act of 1982, P.L. 97-255, which revised some of the reporting and administrative standards for agency heads while leaving the requirements and objectives essentially unchanged. [Ref. 3:p. 1]

These legislative documents, combined with the revised Office of Management and Budget Circular A-123 of 1983, established the internal control policy for agencies within the framework of the Federal Government.

Policy. Agencies shall maintain effective systems of accounting and administrative control. All levels of management shall involve themselves in assuring the adequacy of controls. New programs shall incorporate



effective systems of internal control. All systems shall be evaluated on an ongoing basis, and weaknesses, when detected, shall be promptly corrected. Reports shall be issued, as required, on internal control activities and the results of evaluations. [Ref. 3:p. 2]

## **B. OBJECTIVES OF INTERNAL CONTROL**

The objective of an internal control system for a government is best described by the following:

Establishing and maintaining an internal control structure is an important management responsibility. Good internal controls are essential to achieving the proper conduct of government business with full accountability for the resources made available. They also facilitate the achievement of management objectives by serving as checks and balances against undesired actions. An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

[Ref. 4:p. 4.7]

Within this basic definition, internal control objectives have been further delineated into two categories, general and specific. The general aspect of the objectives are their universal applicability to all government entities. The Army has defined these broad objectives for the NAFI internal control system to ensure:

- (1) Adherence to applicable laws, regulations, and policies
- (2) Transactions are carried out as authorized
- (3) Resources are safeguarded from unauthorized use or disposition
- (4) Financial and statistical records and reports are reliable and accurate

- (5) Resources are efficiently and effectively managed.  
[Ref. 5:p. 1]

Each manger is responsible to translate these general objectives into specific objectives which relate to the activity for which he or she is responsible, with the goal of meeting the broad objectives across the entire business activity.

The Federal Managers' Financial Integrity Act supports this view of broad objectives. The act specifies that internal control objectives are to provide management with reasonable assurance that:

- (1) Costs and obligations conform with current law
- (2) Assets are protected from loss, waste, misappropriation, or unauthorized use
- (3) Accounting functions are performed accurately so that reliable financial reports and statistical data may be obtained. [Ref. 3:p. 5]

The internal control objectives provide the overview for the purpose and function of internal control systems. To implement these objectives, internal control standards have been developed by the Comptroller of the United States to establish the criteria by which internal control system quality is to be measured and evaluated. [Ref. 6:p. 6]

#### C. INTERNAL CONTROL STANDARDS

The GAO has established 12 Standards which have been subdivided into five general internal management control standards and six specific internal management control

standards. The last standard relates to resolution of audit results in a prompt manner [Ref. 7:p. 124] The NAFI is responsible for adherence to these same standards, as directed by Army Regulation 11-2, which considers the standards, and execution of them, to be the basic Federal Managers' Financial Integrity Act responsibility of every Army manager.

[Ref. 6:p. 6]

The following is a list of the general and specific standards with a brief explanation of each. [Ref. 6:p. 6-8]

#### General Standards:

##### (1) Reasonable Assurance

Reasonable assurance implies and recognizes that the cost of implementation of internal controls must be cost effective and practical. The attainment of 100% assurance is not feasible, but every attempt must be made to achieve a satisfactory level of confidence given constraints of cost, staffing, and risk. Judgement is a key factor in implementing this standard and may require frequent review to meet current or changing needs.

##### (2) Supportive Attitude

Management is required by this standard to show a consistent, positive attitude toward the implementation and importance of the internal control program within their area of responsibility. It is essential that this attitude be demonstrated and projected to foster within subordinates the

absolute importance of a well functioning and effective control system. Clear lines of authority must be established in this effort and personnel integrity manifested to nurture employee participation.

(3) Competent Personnel

Personnel integrity must be maintained and employees must have requisite training to accomplish assigned job tasks. This standard is achieved by implementing an active code of conduct, providing necessary job training, and evaluating personnel on a continuing basis. Managers have added responsibility to enact and maintain systems of internal controls and should have this as a major element of their job review.

(4) Control Objectives

These are the objectives the manager or agency authority establishes to meet the requirements of the particular business activity, being developed for the specific transaction cycles which are appropriate. These objectives should be consistent with those broad objectives established under the Federal Managers' Financial Integrity Act.

(5) Control Techniques

Control techniques are the mechanisms that are actually used to implement the internal control system. Techniques must be effective and efficient to satisfy the objectives of internal controls. Included in this area are physical measures, specific policies and procedures, and

organizational arrangements. These techniques need to be practical in actual use and they need to produce the desired benefit with minimum implementation effort. The critical control techniques make up the specific standards and follow in the next few paragraphs.

#### Specific Standards:

##### (1) Documentation

The documentation standard requires that all pertinent information and transactions be recorded in a systematic way. The documentation is to be readily available for examination by appropriate authority. The internal control system is to be clearly documented and should identify transaction cycles and the related objectives and control techniques which are in place.

##### (2) Recording of Transactions and Events

For information to be relevant to the manager and the agency as a whole, transactions of significance must be promptly recorded and accurately classified. This information and the maintenance of the recording process is crucial to the ability of the organization to produce meaningful and accurate financial reports.

##### (3) Execution of Transactions and Events

To ensure that only authorized transactions and use of assets occurs, steps must be instituted to ensure that only authorized personnel approve transactions. This authorization should be clearly delineated and serves as the most effective



link to prohibit unauthorized or illegal contracts or agreements.

(4) Separation of Duties

To prevent wrongful or erroneous acts from being either hidden or undetected, no single individual should be in a position to control all key events in a cycle or transaction. Prevention is assured by dividing key duties between individuals. Key duties include authorizing, issuing, receiving, making payments, and auditing transactions.

(5) Supervision

Supervisors should constantly review and approve work performed by employees. To ensure the proper flow of work, supervisory involvement must be present to detect weaknesses in training, understanding, and performance. The supervisor is also to supervise the implementation of the internal control process to ensure effectiveness and efficiency.

(6) Access to and Accountability for Resources

To reduce the risk of loss or unauthorized use, a system of accountability for resources must be employed. Individuals or organizations responsible for custody and maintenance of assets should be clearly defined in writing with a systematic, periodic review of such responsibilities.

## Audit Resolution and Accounting System Standard:

### (1) Prompt Resolution of Audit Findings

This standard specifies that managers are to respond promptly to audit findings, making appropriate corrections as necessary within required time guidelines.

The objectives and standards form the framework and expectations for an internal control system. To understand the extent to which an internal control system meets these guidelines, a plan of investigation must be formulated. Planning an internal control review is required to know what areas are necessary to examine and what steps will be required to complete an evaluation.

#### D. PLANNING INTERNAL CONTROL REVIEW

Planning an internal control review requires following relatively standard guidelines. To begin a review, the evaluator must decide on the scope of the review and identify the internal control objectives which are to be met

[Ref 4:p. 6.14]. The Department of the Army has established a planning outline for review of internal controls for NAFIs.

[Ref 5:p 3,4]

The first step in this planning phase is gathering documentation for internal control identification. This step includes review of applicable regulations, rules, and legislative guidance. It also includes review of standard operating procedures, organizational charts, and mission

statements. The documented evidence allows the evaluator to establish the event or transactions cycles which are pertinent to the operation under evaluation. [Ref 5:p. 32]

Having identified the event cycles of the business, the second step is to walk through the various processes to gain a fuller understanding of the business and its functional characteristics. [Ref 5:p. 4]

The third step involves preparation of flowcharts for all the event cycles under investigation. Flowcharts are used to document the findings of the previous steps. Properly prepared flowcharts will identify in a graphic fashion all of the transactions which occur in an event or transaction cycle. [Ref 8:p. 84]

The flowcharts are used to complete the fourth phase of the internal control review by allowing the evaluator to further clarify and verify the event cycles. [Ref 5:p. 4]

The fifth and last step of the planning process requires review of vulnerability and the determination of risk. Risk is the uncertainty that an evaluator faces in uncovering errors, loss, or wrongdoing in spite of the evaluation effort. This risk is often considered to occur in two categories; inherent risk and control risk.

Inherent risk is the estimate on the part of an evaluator that material errors are present in a system without internal controls being present [Ref 9:p. 256]. Such risk is related

to the nature of a business and the demonstrated business practices which are used.

Control risk is the assessment that errors of a material nature will occur within a business cycle even though internal controls are present [Ref 9:p. 256]. Control risk relates to the effectiveness of the internal control system implemented within a transaction cycle.

Inherent and control risk can occur in several related areas of importance with two major areas being of particular interest. The first of these is financial, e.g. the loss of assets by fraudulent actions such as theft. The second is in accounting, where records and reports may not be properly maintained or safeguarded [Ref 8:p. 2]. These areas of risk are always present and internal controls must be implemented to reduce them to the lowest practical level, while recognizing that they can never be eliminated completely. The degree to which control procedures meet the objectives of internal control and reduce these areas of risk to acceptable levels are established through the process of evaluation.

#### **E. EVALUATING INTERNAL CONTROLS**

The process of evaluating internal controls centers on the understanding gained about the business operation during the planning phase. Having fully identified the transaction cycles that are pertinent to the review, the evaluator must

now devise methodologies to test the effectiveness of the internal controls to meet objectives and standards.

Tests of controls are employed to establish effectiveness of the control system. These tests can be divided into two groups, functional and operational [Ref 8:p. 108], with functional testing being further divided into three subcategories.

The first subcategory of functional testing is examination of evidence. This is simply the review and inspection of documentation for required signatures, approval evidence, or other proof of a control being applied to transactions. Reperformance is the second functional control, and it is the reworking or recomputing of work processes of employees that are involved in the transaction cycle. The third functional test is observation. The evaluator watches the normal processes of employees to ensure management controls are being implemented correctly. [Ref 8:p. 108]

Operational tests deal with the application of resources in an efficient manner. Review of operation controls is primarily concerned with items of resource planning, organization, and decision making. These controls are typically tested by documentation, because reperformance and observation are difficult to implement. [Ref 8:p. 110]

In the performance of functional tests, testing levels have to be established to ensure that representative samples are taken to approximate population statistics accurately.



This can be achieved through the use of attribute sampling schemes to determine appropriate sample sizes relating to the acceptable risk the evaluator is willing to accept and the total number of deviations or errors the evaluator will allow in the population. Attribute sampling is designed for determining the presence or absence of a given attribute within a population and is well suited to tests of controls which offer simple "yes/no" or "present/absent" verification [Ref 9:p. 419-421]. The goal is to establish evidence for the effectiveness of a control with the minimum necessary testing.

Once testing is complete, the evaluator must make a decision concerning the effectiveness of the internal control system and report weaknesses to appropriate authority to promote changes which will allow the system to function reliably and efficiently.

Since public institutions are under such close scrutiny and in competition for precious dollars within current budget constraints, the ability to operate in an efficient manner is absolutely essential. Inefficiency makes these business activities extremely vulnerable to large funding cuts and potentially reduces the quality and level of service they can provide. These realities require that all Government agencies and entities employ effective internal control systems to reduce risk and vulnerability to the lowest practical level to safeguard assets in the public trust.

### III. OBTAINING AN UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

#### A. INTRODUCTION

Fort Ord is an Army Base located in Monterey County, in central California, and covers 26,000 acres. As part of the Morale, Welfare, and Recreation (MWR) program on the base, the Fort Ord Golf Course complex is operated to provide beneficial recreation opportunities to active duty, retired, and civilian government personnel within the local and surrounding geographic area.

The operation consists of two 18-hole championship golf courses, complete Pro Shop, driving range facility and a newly renovated dining facility. The operations include the retail sales of food, beverages, golf equipment, golf supplies, clothing, and payments for the use of the golf course in the form of greens fees and golf cart rentals. Profits from the facility not only provide operating capital for the golf course operation, but are an important source of funding for other desirable but less profitable MWR activities on the Fort Ord Post.

The Golf Course operation at Fort Ord is one of a number of NAFI's which comprise the Department of Personnel Community Activities (DPCA). The DPCA is the central authority for the MWR programs on the post and is composed of several divisions.

The fiscal division of DPCA is the Resource Management Division (RMD), which provides financial fund approval and oversight through the Fund Manager to the assigned NAFIs, which are the recreational businesses of MWR. The RMD submits financial documents to the Central Accounting Office (CAO) for accounting and record keeping purposes. The CAO performs the accounting and record keeping functions for all regional DPCAs and business activities. Though not geographically co-located with the NAFI or DPCA, the CAO receives transmitted documentation and records through mail and telecommunication channels. Some reports and documents, such as time and attendance reports, are also submitted directly by the NAFI to the CAO, as well as via the RMD, as a control measure for the CAO. Another branch of DPCA is the Civilian Personnel Office (CPO), which is responsible for hiring employees to fill job vacancies within the DPCA. The CPO is responsible for maintaining the personnel records of golf course employees.

Internally, the Fort Ord Golf Course is comprised of a manager, assistant manager, and four divisions with an assigned division manager in each area. Approximately 60 personnel are assigned to the golf course administration, maintenance, sales, and restaurant operations. An organization chart of the NAFI showing external and internal structures is provided in Figure 3-1.

To ensure the continued self-support of the golf course operation and the continued funding of desirable but

unprofitable MWR activities, it is the responsibility of management to operate in the most effective and efficient manner possible. This requires identifying and eliminating areas of waste, loss, or misuse of assets under management control. To achieve this objective, business operations are designed with internal control measures aimed at detection and elimination of loss and inefficiencies. The review of these internal controls and their effectiveness begins by obtaining an understanding of the controls.

An evaluator of internal controls must obtain an understanding of the elements of a business prior to assessing the effectiveness of an internal control system. This understanding must extend to the normal and routine internal transactions which occur for the business as well as to the external relationships that exist. Understanding is usually gained through observation of daily procedures, interviews of client personnel, the client's standard operating procedures and manuals, and inspection of documents and records [Ref. 8:p. 72].

The understanding gained through this process must be recorded as evidence for the sequence of transactions and operations. Several tools are employed to document the understanding gained through this process and aid in clarifying the processes and substantiating the understanding. The most common tools used in the documentation of an understanding of internal control systems are narrative

descriptions, flowcharts, and internal control questionnaires [Ref. 9:p. 304].

The narrative description is a simple plain language interpretation of the transactions of interest in the business. This is supported by the use of flowcharting to

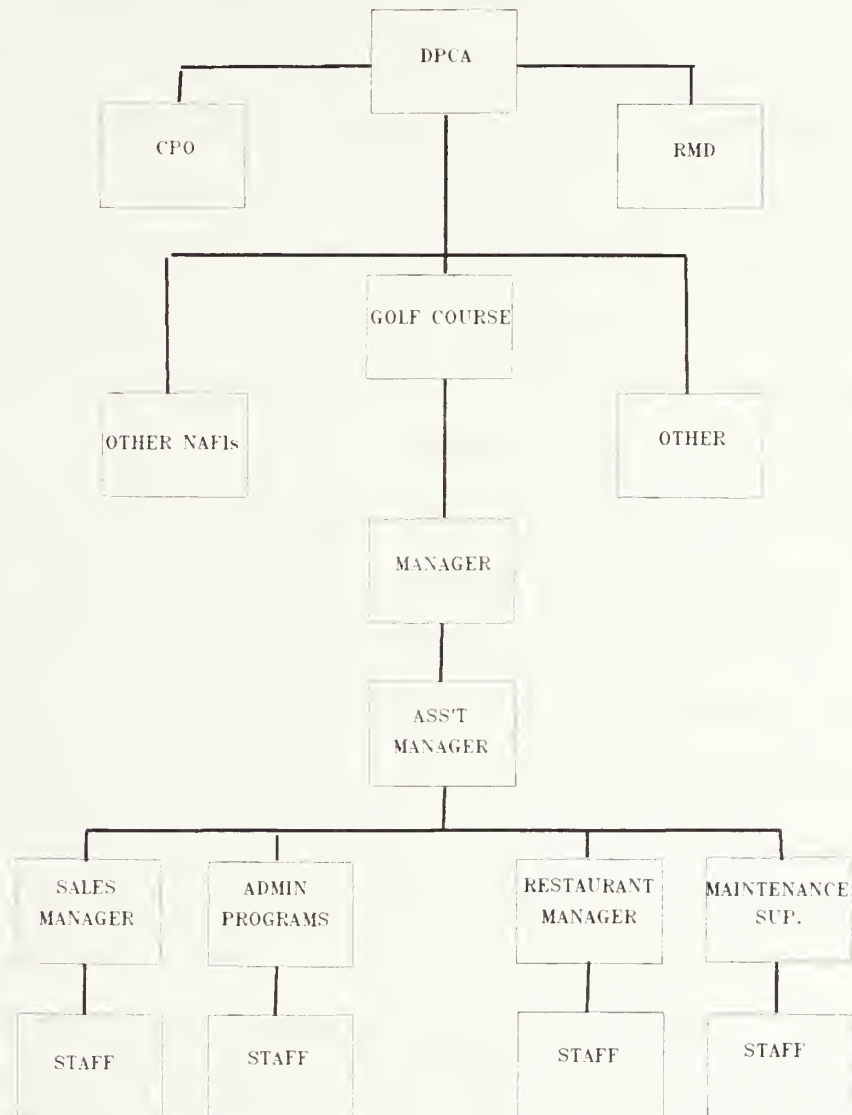


Figure 3-1: Fort Ord Golf Course Organization Structure.



present the same information in a graphic, diagrammatic view. The purpose is to give the evaluator a full range of knowledge concerning the steps in each transaction cycle. The internal control questionnaire is designed to reduce internal control requirements mandated by higher authority to "yes"/"no" responses. The process requires questions which are specific in nature to the particular transaction cycle. A "no" response to an internal control question is considered a potential weakness in internal controls and represents an area that cannot be tested due to lack of a control to evaluate [Ref. 8:p. 52]. The presence of a weakness does not mean that actual errors or losses have occurred, but indicates an area where potential loss could occur because adequate controls are not in place to prevent a problem.

For the transaction cycles under consideration in this study, narrative descriptions, flowcharts, and internal control questionnaires are important to a full understanding of those cycles and are presented for each cycle in consecutive sections and subsections of this chapter.

The narrative descriptions and flowcharts were developed from observation of the transaction cycles and through interviews with the manager, payroll clerk, receiving clerk and cashiers. Internal control questionnaires were developed from the requirements established for the NAFI in Army Regulations 215-1, 215-2, 215-3, 215-4, and 215-5, of October, 1990. These regulations are the primary operating documents

for the NAFI and give the minimum requirements for operation of the transaction cycles.

The cycles which are the subject of this study include the cash receipt and control cycle, payroll cycle and the inventory receipt and control cycle.

## **B. CASH RECEIPT AND CONTROL CYCLE**

### **1. Narrative Description**

Cash receipt can occur through five possible cash registers during the business day. Two of the cash registers are located in the Pro Shop, two are located in the dining room and one is in a beverage shack located outside the main building on the golf course grounds.

The cashiers receive \$200 in their cash drawers at the beginning of each shift or the opening of a new cash register. Each cashier is responsible for his or her own drawer and is to be the sole operator of that cash drawer. Upon receipt of the change fund, the cashier counts the change and signs the daily cashier's record, DA Form 4082, to acknowledge receipt of the change. This record is placed in the safe as a receipt for the change and the drawer. The record is not prenumbered and is duplicated in the NAFI office to ensure an adequate supply.

The cash registers are computerized and use product identification numbers for entry into the system. The computerization provides automatic price information to the

cashier and customer. Each item sold reflects the price entered into the computer system by the manager of the pro shop. As sales occur, the customer is provided a sales receipt which is generated automatically by the cash register to verify the sale. When checks are accepted for payment, they are stamped with the endorsement "For Deposit Only" immediately upon receipt and are placed into the cash drawer. Credit card sales are also an acceptable means of payment but a \$25 minimum charge limit is imposed. Credit cards are verified by the use of an electronic approval system and the authorization number is entered on the credit slip along with the initials of the cashier receiving the authorization.

When the cashier has completed the shift, the cash register is closed. The manager takes readings of the cash register by means of a computer generated register tape. The mechanism that controls the reading is accessible only to the individual reading the register and is protected by a locked entry system. The reading process generates a register tape which reflects the starting total and the ending total in the register since the last reading, taking into account discounts and returns. The cashier is not apprised of the amount that should be in the cash register. The cashier then counts the cash present in his/her cash drawer and documents the cash count on the Daily Cashier's Record. The Daily Cashier's Record is again signed by the cashier to signify that the money is turned in. The manager or designated representative

who receives the cash also signs to indicate agreement with the cash count and to signify receipt of the cash. After attaching the register tape that was generated at the register closing to the Daily Cashier's Record, the cash, register tape and Daily Cashier's Record are then reconciled by the individual assigned to close. The documentation and cash are placed in the safe at the end of the day or at the end of the cashier's shift. The Cashier's Record and money is then received by the accounting technician who uses the combined records from the various cashiers to compile the Daily Activity Report. Examples of the Daily Cashier's Record and Daily Activity Report are included in the Appendix.

The cash receipts are combined by the accounting technician, and a deposit slip is filled out in triplicate. The deposit amount is entered on the Daily Activity Report along with a breakdown of receipts by transaction type. The sum of the cash deposit and all other debit amounts are totalled against the sum of all credit amounts for the day and the sums are inspected for agreement.

The three copies of the deposit slip are distributed as follows: one to the bank with the deposit, one maintained on file, and the third sent to the Central Accounting Office along with a copy of the Daily Activity Report.

The deposit is locked in the safe until it is picked up by a courier from the Department of Personnel Community Activities (DPCA), which is the overall supervisor for the

Fort Ord NAFIs. The transfer of the money to the courier is done by use of a receipted bank bag, which is then transported to the bank. The bank sends a copy of the deposit slip to the Central Accounting Office for verification against the deposit slip and Daily Activity Report submitted by the NAFI. For amounts over \$5000, an armed guard accompanies the courier.

The Daily Activity report, Cashier's Daily Records with register tapes, deposit slip copy, photo copy of tendered checks, duplicate credit card slips, and bank bag receipt tapes are then collated and kept on file for 90 days at the NAFI. In addition, itemized sales reports from the cash registers are generated and maintained with the copy of the Daily Activity Report.

## 2. Flowchart

The cash receipts and control cycle flowchart is displayed in Figure 3-2.



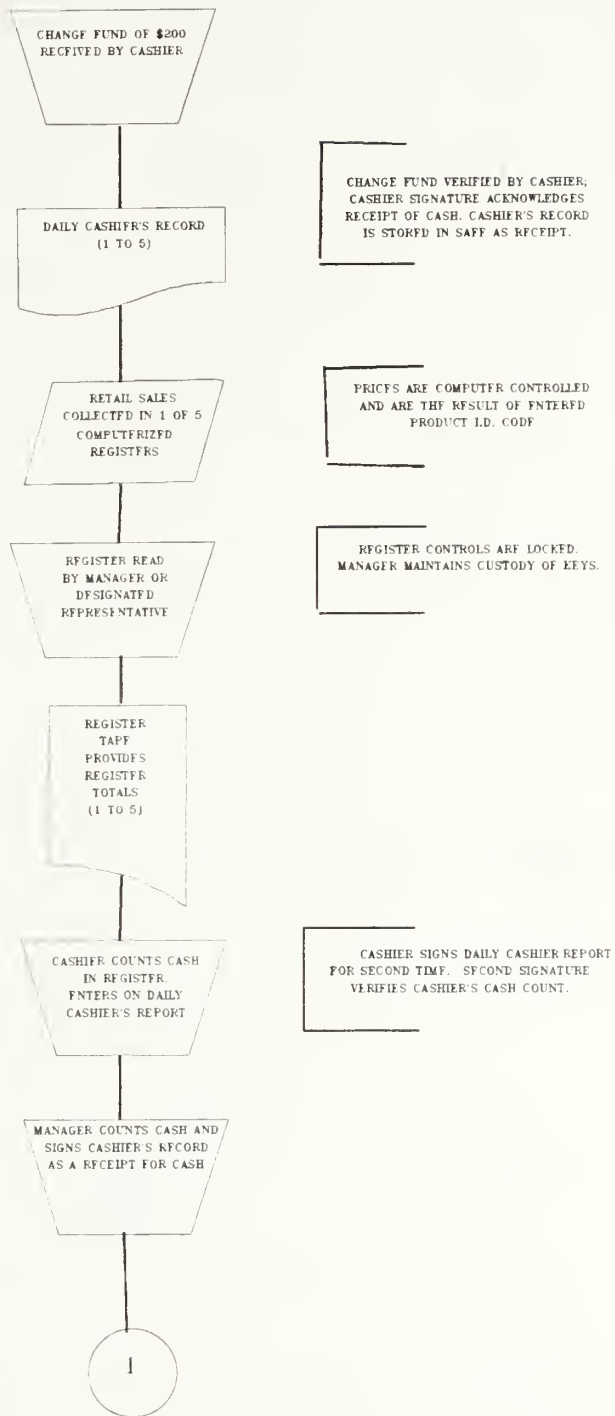


Figure 3-2: Cash Receipts and Control Flowchart

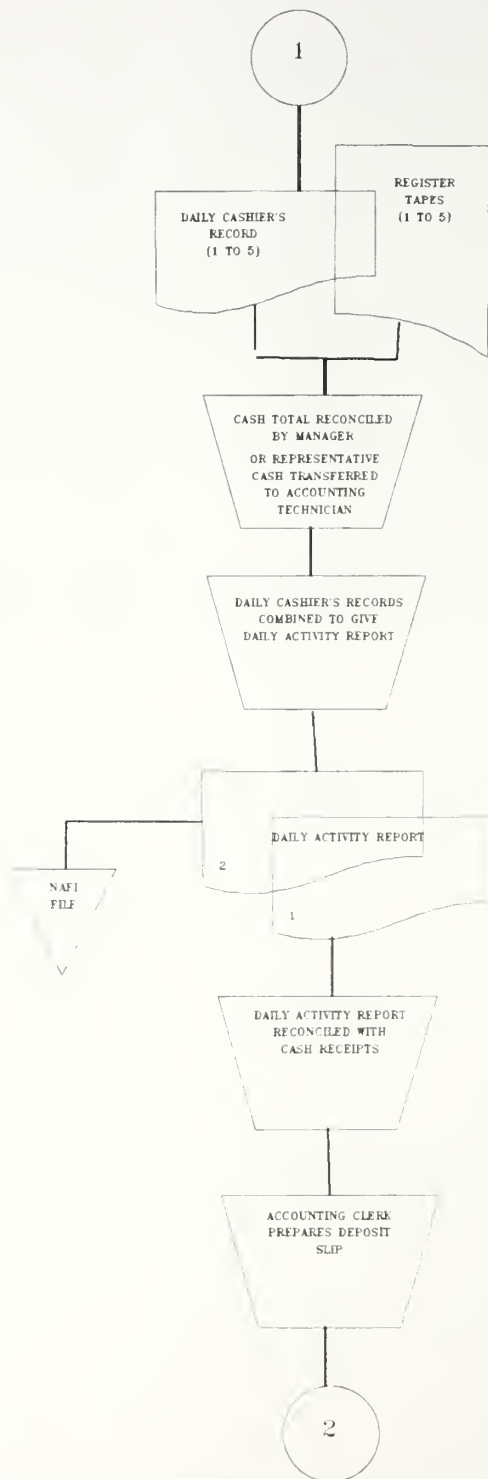


Figure 3-2 continued.

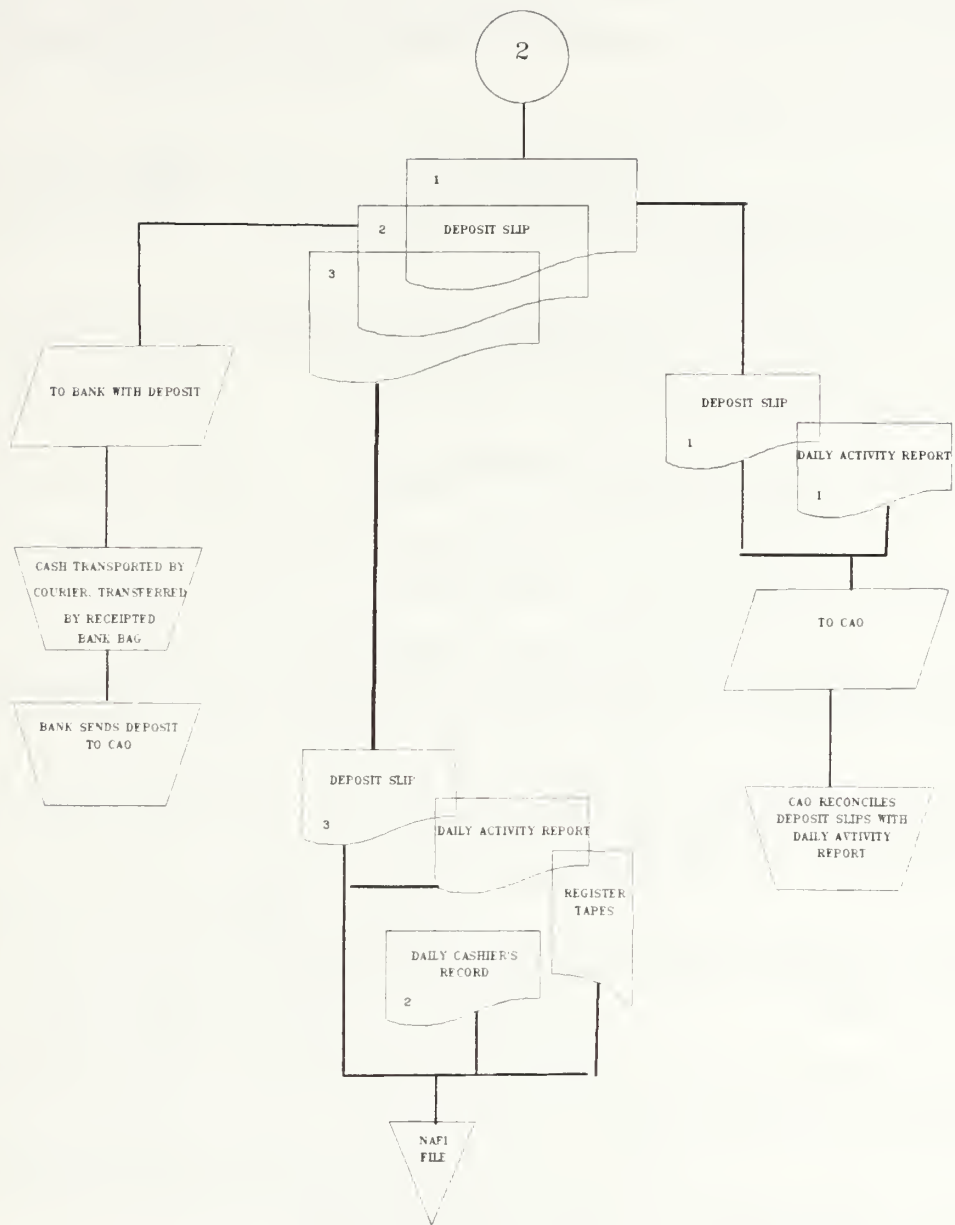


Figure 3-2 continued.

### 3. Cash Receipts and Control Questionnaire

The following questions address the controls that Army regulations state should be in effect in a NAFI for this transaction cycle. Specific responses to these questions are discussed in Chapter V.

- |                                                                                                                                                             | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
| 1. ARE OPERATING CHANGE FUNDS SIGNED FOR BY THE REGISTER OPERATOR ON THE DAILY CASHIER'S RECORD?                                                            | ( )        | ( )       | ( )       |
| 2. IS THE DAILY CASHIER'S RECORD PLACED IN A SAFE AFTER OBTAINING THE CASHIER'S SIGNATURE AS A RECEIPT ?                                                    | ( )        | ( )       | ( )       |
| 3. IS ONLY ONE CASHIER ASSIGNED TO A SINGLE CASH REGISTER AT A TIME?                                                                                        | ( )        | ( )       | ( )       |
| 4. IS THE COMBINATION OF EACH SAFE ONLY KNOWN TO AUTHORIZED PERSONNEL?                                                                                      | ( )        | ( )       | ( )       |
| 5. ARE CASH RECEIPTS, CHANGE FUNDS AND ALL MONIES SECURED IN AN APPROVED LOCKED SAFE AT ALL TIMES?                                                          | ( )        | ( )       | ( )       |
| 6. IS THE AMOUNT RUNG UP ON REGISTERS VISIBLE TO THE CUSTOMER OR IS AN IMPRINTED OR WRITTEN CUSTOMER RECEIPT PROVIDED TO THE CUSTOMER?                      | ( )        | ( )       | ( )       |
| 7. ARE PRENUMBERED RECEIPTS USED FOR CASH COLLECTIONS WHEN CASH REGISTERS ARE NOT USED?                                                                     | ( )        | ( )       | ( )       |
| 8. DOES SOMEONE OTHER THAN THE SALES PERSON OR CASH REGISTER OPERATOR READ THE REGISTER?                                                                    | ( )        | ( )       | ( )       |
| 9. ARE CASH REGISTER TAPES REMOVED FROM THE MACHINES BY SOMEONE OTHER THAN THE CASHIER?                                                                     | ( )        | ( )       | ( )       |
| 10. DOES THE BRANCH MANAGER OR A DESIGNATED REPRESENTATIVE COUNT THE DAILY RECEIPTS AND COMPARE THEM AGAINST THE REGISTER READING OR PRE-NUMBERED RECEIPTS? | ( )        | ( )       | ( )       |

- |                                                                                                                                                   | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|---------------------------------------------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
| 11. IS A LISTING OF DISHONORED CHECKS MAINTAINED FOR CASHIERS TO PREVENT REPEAT OFFENSES OR LOSS?                                                 | ( )        | ( )       | ( )       |
| 12. ARE CASH OVERAGES AND SHORTAGES INVESTIGATED AND REFLECTED ON THE DAILY ACTIVITY REPORT?                                                      | ( )        | ( )       | ( )       |
| 13. ARE THE SET BACK AND READING KEYS TO THE CASH REGISTER(S) IN THE POSSESSION OF THE MANAGER OR HIS/HER DESIGNATED REPRESENTATIVE AT ALL TIMES? | ( )        | ( )       | ( )       |
| 14. IS DIRECT SUPERVISION GIVEN TO THE PERSON CHARGED WITH OPENING THE MAIL, AND IS THE PERSON SOMEONE OTHER THAN THE CASHIER?                    | ( )        | ( )       | ( )       |
| 15. IS A RECORD MADE IMMEDIATELY UPON RECEIPT OF CASH OR CHECKS?                                                                                  | ( )        | ( )       | ( )       |
| 16. ARE ALL CHECKS STAMPED IMMEDIATELY UPON RECEIPT "FOR DEPOSIT ONLY"?                                                                           | ( )        | ( )       | ( )       |
| 17. IS CASH KEPT IN A COMBINATION, THREE TUMBLER LOCKED, FIRE RESISTANT SAFE DURING NON-OPERATING HOURS?                                          | ( )        | ( )       | ( )       |
| 18. IS THE NAFI PRECLUDED FROM CASHING ITS OWN CHECKS?                                                                                            | ( )        | ( )       | ( )       |
| 19. ARE SPECIFIC DOLLAR LIMITS ESTABLISHED FOR CASHING MEMBER'S CHECKS?                                                                           | ( )        | ( )       | ( )       |
| 20. IS THE PERSON CASHING A CHECK REQUIRED TO SHOW IDENTIFICATION AND HAVE HIS/HER NAME, ADDRESS, AND PHONE NUMBER ON THE CHECK?                  | ( )        | ( )       | ( )       |
| 21. ARE OVERRINGS VERIFIED AND VOIDED ON THE CASH REGISTER TAPE AND INITIALED BY THE CASHIER'S SUPERVISOR?                                        | ( )        | ( )       | ( )       |
| 22. ARE CASH REGISTERS OPERATED ONLY WITH THE DRAWERS CLOSED?                                                                                     | ( )        | ( )       | ( )       |
| 23. ARE CASH REGISTERS EMPTIED AND LEFT OPEN WITH THE REGISTER CONTROLS LOCKED AT THE CLOSE OF EACH BUSINESS DAY?                                 | ( )        | ( )       | ( )       |



- |                                                                                                                | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|----------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
| 24. ARE DAILY ACTIVITY REPORTS PREPARED EVERY DAY WHETHER OR NOT A DEPOSIT IS MADE?                            | ( )        | ( )       | ( )       |
| 25. ARE DEPOSIT SLIP TOTALS RECONCILED TO DAILY ACTIVITY REPORTS FOR AGREEMENT?                                | ( )        | ( )       | ( )       |
| 26. ARE BOND AMOUNTS MAINTAINED FOR CLASS 1 AND CLASS 2 EMPLOYEES IN ACCORDANCE WITH ARMY REGULATION 215-2?    | ( )        | ( )       | ( )       |
| 27. ARE SPECIFIC PERSONNEL AUTHORIZED IN WRITING TO READ CASH REGISTERS AND RECEIVE CLOSING BALANCES?          | ( )        | ( )       | ( )       |
| 28. ARE CASH RECEIPTS DEPOSITED IN TOTAL DAILY?                                                                | ( )        | ( )       | ( )       |
| 29. ARE ALL CHECKS LISTED SEPARATELY ON THE BANK DEPOSIT SLIPS OR A MACHINE TAPE ATTACHED TO THE DEPOSIT SLIP? | ( )        | ( )       | ( )       |
| 30. ARE BANK DEPOSITS MADE BY SOMEONE OTHER THAN THE CASHIER?                                                  | ( )        | ( )       | ( )       |
| 31. ARE DUPLICATE DEPOSIT SLIPS STAMPED BY THE BANK AND FORWARDED TO THE CENTRAL ACCOUNTING OFFICE?            | ( )        | ( )       | ( )       |

## C. PAYROLL CYCLE

### 1. Narrative Description

The golf course employs 60 individuals in four basic divisions, with a manager assigned to each division. All employees have timecards except the golf course manager and the assistant manager, who receive salaries. The timecards are generic and are purchased by the NAFI through supply channels. The timecards are filled out with employees' names and social security numbers by the payroll clerk and are

placed into a rack inside the administrative office in clear view of the administrative personnel. Employees use the same timecard for a period of two weeks, after which new timecards are prepared by the payroll clerk. Division managers are responsible to monitor attendance of personnel assigned to them and ensure that absenteeism is reported to the payroll clerk.

Employees punch-in and punch-out by use of an ordinary mechanical time clock which is also located in the administrative office. The time clock and timecards are in view of the manager as well as the administrative personnel occupying the office.

At the end of the two week pay period, the payroll clerk collects the time cards and counts them to ensure that the number of timecards is equal to the number of employees currently on the payroll. Times recorded on the timecards are then transcribed, by hand, to the Nonappropriated Funds Time and Attendance Report (DA Form 4850) for each employee. This report includes all hours worked, overtime, annual leave, and sick leave taken during the reporting period. The employee is identified on the form by use of an employee identification number which is the same as the individual's social security number. An example of this form is included in the Appendix. The DA Form 4850 is then signed by the manager or assistant manager certifying that all time worked and leave taken for the period is correct as reported. This signature also serves

as the authority to grant entitlement to the employee for wages earned. [Ref. 10:p. 30]

The time and attendance report is completed in triplicate for each employee and the three copies are distributed, with one going to the Resource Management Division (RMD), one to the CAO, and one copy held on file. The DA Forms 4850 are transmitted to the CAO by mail along with a Nonappropriated Fund Document Transmittal Form (DA Form 4853) with a count of enclosed payroll documents to ensure all personnel are paid. The CAO uses the information on the DA Form 4850 to prepare the paychecks which are sent to the RMD. RMD delivers the NAFI checks to the payroll clerk, who ensures that they are all present. The payroll clerk is then responsible for providing payroll checks to the employees on payday. Supervisors pick up checks for their division and are responsible for individual delivery to division personnel. Undelivered payroll checks are returned to the payroll clerk who stores them in the safe until delivery can be made. If an individual has terminated employment and a check has been received, that check is returned to RMD by the payroll clerk for cancellation through the CAO.

All hiring is administrated by the Civilian Personnel Office. When vacancies occur in staffing, openings are advertised and filled through the personnel office which is responsible for maintaining personnel records and establishing individual pay accounts with the CAO. This work is outside

the area of responsibility and control for the NAFI and is not a consideration in this study.

Examples of DA Forms 4850, and 4853 are included in the Appendix.

## 2. Flowchart

The payroll cycle flowchart is presented in Figure 3-3.

## 3. Payroll Control Questionnaire

The following questions address the controls that Army regulations state should be in effect for the NAFI payroll cycle. Specific responses to these questions are discussed in Chapter V.

- |                                                                                                                          | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|--------------------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
| 1. ARE TIMECARDS VERIFIED BY EMPLOYEES' SUPERVISORS FOR ACCURATE TIME AND ATTENDANCE?                                    | ( )        | ( )       | ( )       |
| 2. ARE ALL DUTIES OF POSITIONS DESCRIBED AND AUTHENTICATED BY THE APPROPRIATE SUPERVISOR AND RECORDED ON DA FORM 3435-R? | ( )        | ( )       | ( )       |
| 3. IS TIME, ATTENDANCE, AND LEAVE OF EACH NAF EMPLOYEE MAINTAINED ON DA FORM 4850 AND DA FORM 4850-1-R?                  | ( )        | ( )       | ( )       |
| 4. ARE ENOUGH BLANK DA FORM 4850'S KEPT ON HAND SO THAT THERE ARE ENOUGH FOR A FULL PAY PERIOD?                          | ( )        | ( )       | ( )       |
| 5. IS COPY THREE OF COMPLETED DA FORM 4850 RETAINED AS A FILE RECORD?                                                    | ( )        | ( )       | ( )       |
| 6. ARE ALL DA FORMS 4850 AND DA FORMS 4850-1-R AUTHENTICATED BY THE NAFI MANAGER OR DESIGNATED REPRESENTATIVE?           | ( )        | ( )       | ( )       |

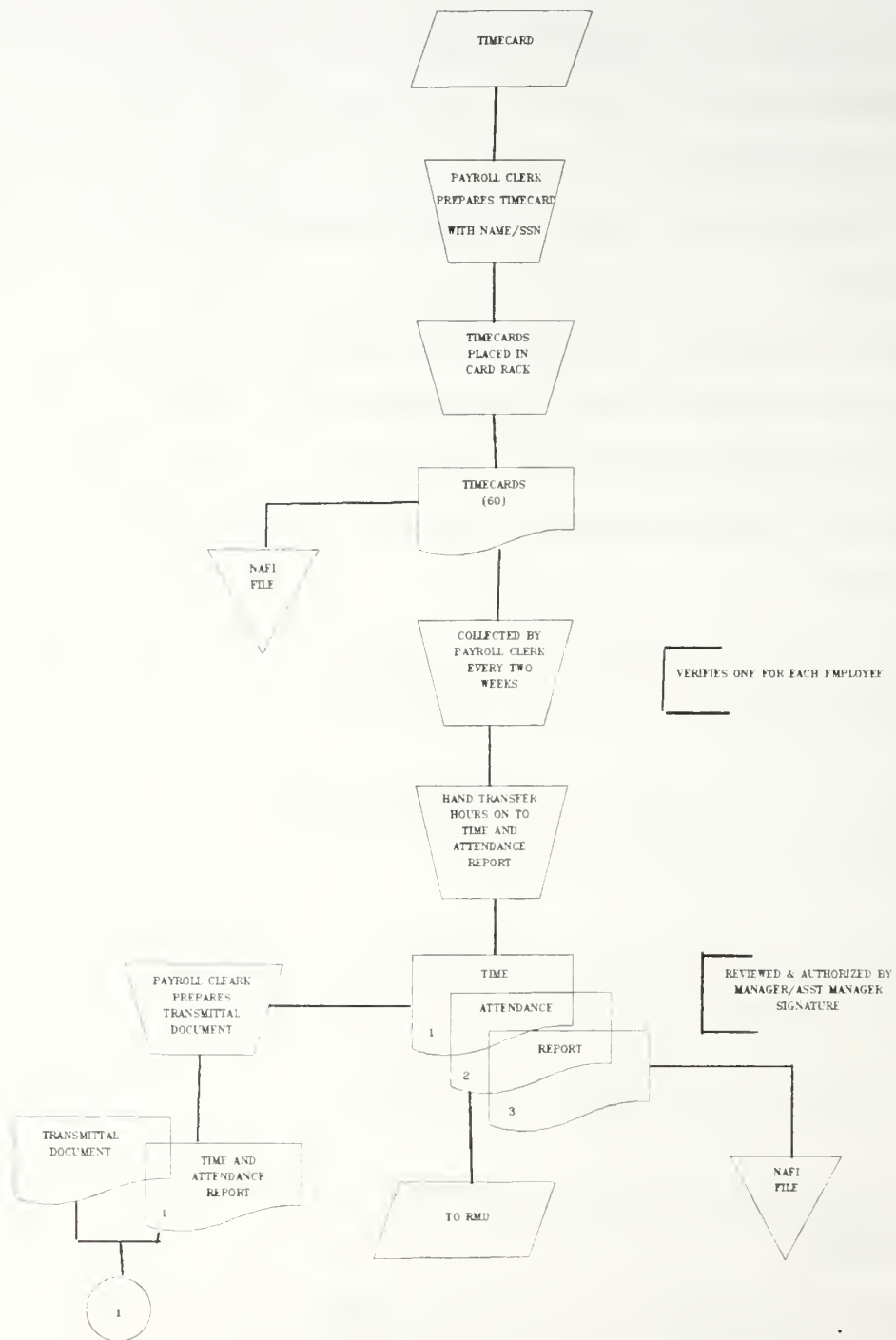


Figure 3-3: Payroll Cycle Flowchart.



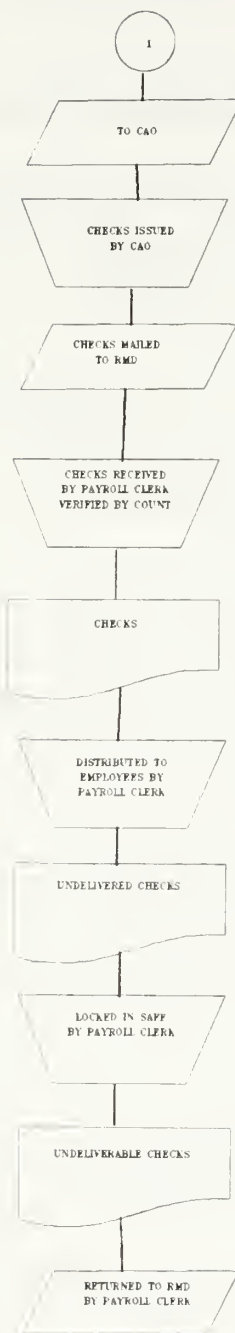


Figure 3-3 continued.

- |                                                                                                                                                                                                                            | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
| 7. ARE ALL CORRESPONDING DA FORMS 4850 AND DA FORMS 4850-1-R SIGNED BY THE SAME PERSON?                                                                                                                                    | ( )        | ( )       | ( )       |
| 8. ARE ALL DA FORMS 4850 AND 4850-1-R TRANSMITTED USING DA FORM 4853-R?                                                                                                                                                    | ( )        | ( )       | ( )       |
| 9. DOES AN AUTHORIZED PERSON REVIEW FOR ACCURACY, COMPLETENESS, CORRECTION OF ERRORS, AND PROPER INITIALS ON ALL CORRECTIONS, AND PROPER SIGNATURE BEFORE SUBMISSION OF DA FORMS 4850 AND 4850-1?                          | ( )        | ( )       | ( )       |
| 10. DOES THE NAFI MANAGER OR SUPERVISOR HAVE POSITIVE MEASURES TO ENSURE SUBMISSION OF DA FORMS 4850 AND 4850-1-R FOR EACH EMPLOYEE WITH HOURS TO BE REPORTED?                                                             | ( )        | ( )       | ( )       |
| 11. ARE ALL NECESSARY CHANGES MADE TO DA FORMS 4850 AND 4850-1-R PROPERLY ANNOTATED ON COPIES TWO AND THREE, AND SIGNED BY A PERSON WHO HAS A PROPER DD FORM 577 (SIGNATURE CARD) ON FILE AT THE SERVICING PAYROLL OFFICE? | ( )        | ( )       | ( )       |
| 12. IS THE PERSON WHO RECEIVES PAYCHECKS FOR DISTRIBUTION AUTHORIZED IN WRITING BY THE NAFI MANAGER?                                                                                                                       | ( )        | ( )       | ( )       |
| 13. ARE PROCEDURES ESTABLISHED FOR THE DISTRIBUTION OF PAYCHECKS TO EMPLOYEES?                                                                                                                                             | ( )        | ( )       | ( )       |
| 14. IS THE RECEIPT, HANDLING AND DISTRIBUTION OF PAYCHECKS SEPARATED FROM THE AUTHORIZATION AND RECORDING OF PAYMENTS?                                                                                                     | ( )        | ( )       | ( )       |
| 15. ARE UNDELIVERED PAYCHECKS SECURED IN AN APPROPRIATE SAFE UNTIL DELIVERY CAN BE MADE?                                                                                                                                   | ( )        | ( )       | ( )       |
| 16. ARE TIMECARDS SAFEGUARDED TO PREVENT EMPLOYEES FROM CLOCKING IN FOR ONE ANOTHER?                                                                                                                                       | ( )        | ( )       | ( )       |

## **D. INVENTORY RECEIPT AND CONTROL CYCLE**

### **1. Narrative Description**

The purchase of inventory items or services begins with a vendor order which is the vendor's estimate of cost to the NAFI for a proposed purchase. The vendor's order is followed by the Army NAF Purchase Request (DA Form 4065-R). The NAF Purchase Request lists items to be purchased or services required by description, quantity, estimated price, extended price and estimated shipping charges. The purchase request also contains any special instructions which may be important to the purchase, such as manufacturer for name brand or manufacturer-specific orders. The capability to specify name brand items is considered essential for the success of retail sales in the pro shop. The purchase request is signed by the NAFI manager and is forwarded to RMD, which has final approval authority for the NAFI. The RMD controls all nonappropriated fund expenditures for the NAFI through the NAFI fund manager, who is located at the RMD.

The request is then forwarded to procurement specialists at RMD, who are responsible for contracting requirements and proper procurement procedures. A procurement specialist prepares the actual purchase order and supplies a copy of it along with a copy of the Purchase Request to the NAFI for record purposes. When items are received, the shipping document is compared to the purchase

order by the NAFI receiving clerk. The receiving clerk inspects the shipped items to ensure that quantities, specifications and condition at delivery are satisfactory. The receiving clerk completes the Material Inspection and Receiving Report (DD Form 250), noting any discrepancies which exist. The receiving report is reviewed by the NAFI manager and signed as final acceptance authority. Receiving reports and shipping documents are then sent to the Central Accounting Office for payment to the vendor. Copies of the NAF Purchase Request, purchase order, shipping document, and receiving report are maintained by the NAFI receiving clerk on file for one year.

Appropriate divisions are notified of deliveries and items are transferred to division control for storage and safeguarding until sale or use.

Examples of DA Form 4065-R and DD form 250 are presented in the Appendix.

## 2. Flowchart

The inventory receipt and control flowchart is presented in Figure 3-4.

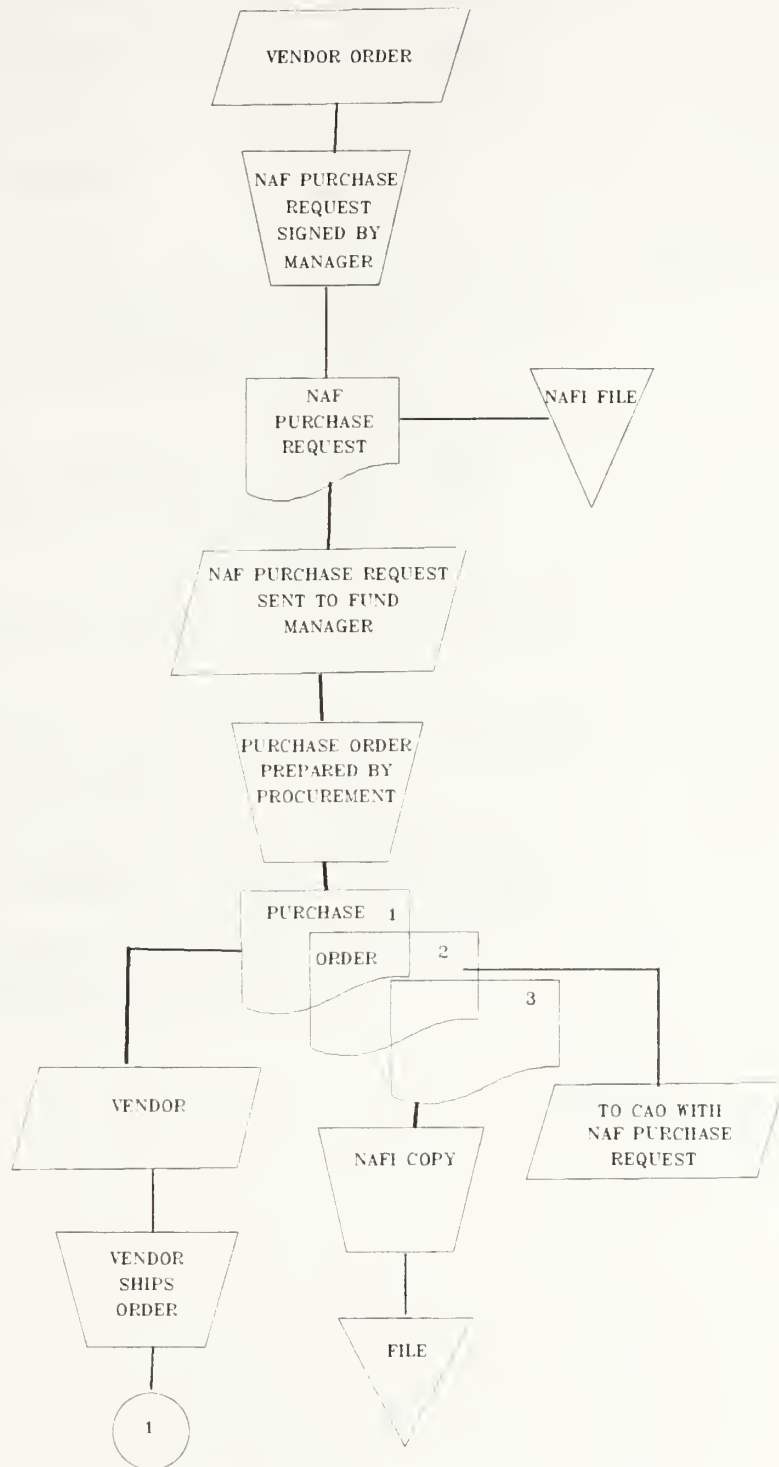


Figure 3-4: Inventory Receipt and Control Flowchart.



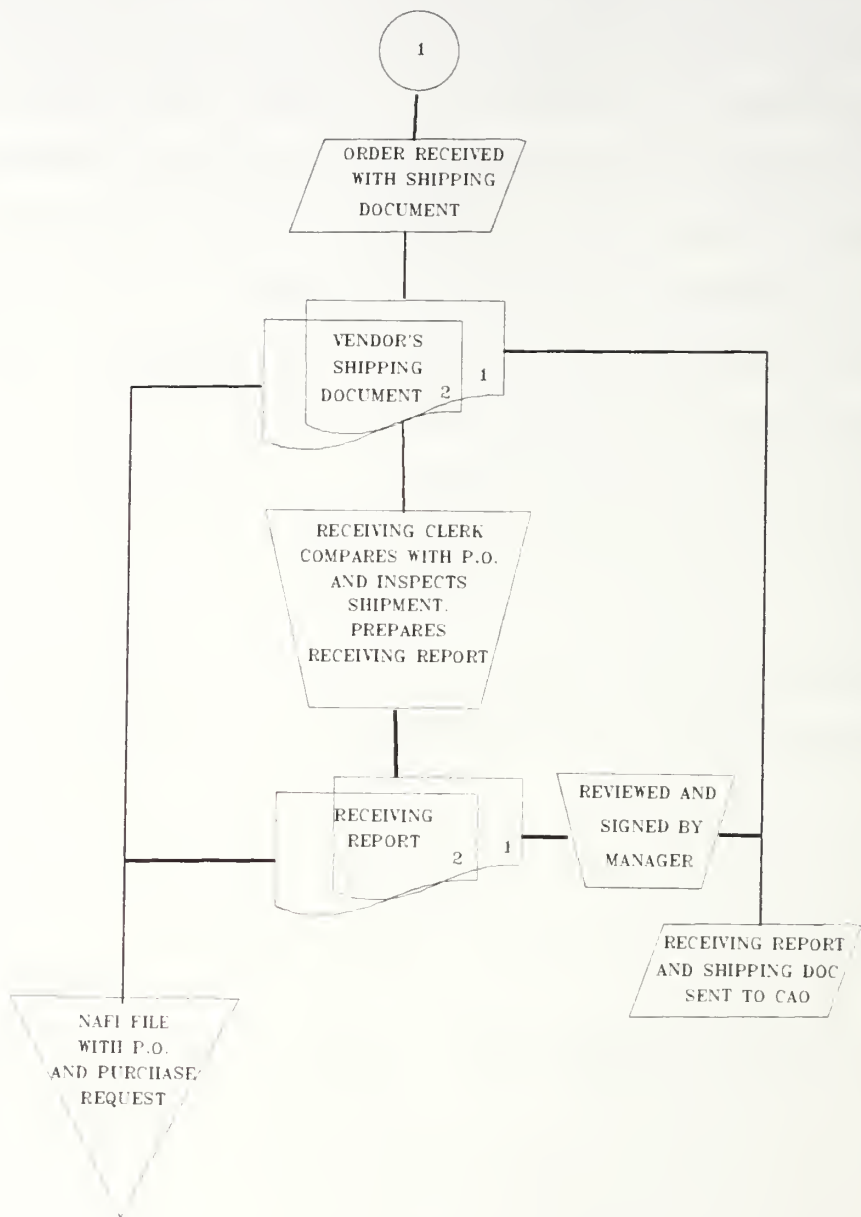


Figure 3-4 continued.

### 3. Inventory Receipt and Control Questionnaire

The following questions address the controls that Army regulations state should be in effect in a NAFI for this transaction cycle. Specific responses to these questions are discussed in Chapter V.

- |                                                                                                                                      | <u>YES</u> | <u>NO</u> | <u>NA</u> |
|--------------------------------------------------------------------------------------------------------------------------------------|------------|-----------|-----------|
|                                                                                                                                      | ( )        | ( )       | ( )       |
| 1. ARE PROCEDURES ESTABLISHED TO ENSURE THAT ALL PURCHASE REQUESTS HAVE PROPER APPROVAL SIGNATURES PRIOR TO SUBMISSION FOR APPROVAL? | ( )        | ( )       | ( )       |
| 2. ARE PURCHASE ORDERS RECONCILED TO SHIPPING INVOICES TO ENSURE THAT QUANTITIES AND QUALITIES RECEIVED CONFORM WITH THOSE ORDERED?  | ( )        | ( )       | ( )       |
| 3. ARE ALL RECEIPTS OF GOODS AND SERVICES RECORDED ON A MATERIAL INSPECTION AND RECEIVING REPORT, DD FORM 250?                       | ( )        | ( )       | ( )       |
| 4. IS ALL MERCHANDISE INSPECTED FOR DAMAGE UPON RECEIPT WITH DAMAGE NOTED ON THE RECEIVING REPORT?                                   | ( )        | ( )       | ( )       |
| 5. ARE RECEIVING REPORTS ROUTED PROMPTLY TO TAKE ADVANTAGE OF CASH DISCOUNTS?                                                        | ( )        | ( )       | ( )       |
| 6. IS RECEIVED MERCHANDISE PHYSICALLY CONTROLLED UPON RECEIPT UNTIL PROPERLY STORED?                                                 | ( )        | ( )       | ( )       |

## IV. EVALUATING THE INTERNAL CONTROL SYSTEM

### A. BACKGROUND

#### 1. TESTS OF CONTROLS

Having gained an understanding of the internal controls present in the NAFI, the next step in the study is to test these controls to evaluate the extent to which they meet management objectives for effectiveness. Tests of controls typically rely on four techniques to examine the functioning of the internal controls [Ref. 9:p. 310].

**Inquiries of appropriate entity personnel.** Although inquiry is not generally a strong source of evidence about the effective operation of controls, it is an appropriate form of evidence. For example, the auditor may determine that unauthorized personnel are not allowed access to... files by making inquiries of the person who controls the ...library.

**Inspection of documents, records, and reports.** Many related activities and procedures leave a clear trail of documentary evidence. ... The auditor examines the documents to make sure they are complete and properly matched, and that required signatures or initials are present.

**Observation.** Other types of control-related activities do not leave an evidential trail. ... For controls that leave no documentary evidence, the auditor generally observes them being applied.

**Reperformance.** There are also control-related activities for which there are related documents and records, but their content is insufficient for the auditor's purpose of assessing whether controls are operating effectively. ... In these cases, it is common for the auditor to actually reperform the control activity to see whether the proper results were obtained. [Ref. 9:p. 310-312]

Combining the information provided by the internal control questionnaires, flowcharts, and narrative descriptions with the information from the four techniques listed above allowed for identification of the key controls which are essential to the effective operation of the internal control system in general, and the transaction cycles specifically. Key controls are those control measures which have the greatest effect on the achievement of control objectives [Ref. 9:p. 307]. The understanding of internal controls gained about the NAFI is confirmed by the tests of controls to form the basis for the evaluation of the overall implemented internal control system. Tests of controls investigate the key controls for each transaction cycle and, through a sampling process, methodically examine for the actual presence and effectiveness of the internal controls to prevent inadvertent or intentional loss, misuse, or waste of NAFI assets.

## **2. ATTRIBUTE SAMPLING**

One technique which is applied in this study to facilitate the testing of controls is attribute sampling. To test the key controls of the transaction cycles, examination of a representative sample of those controls is sufficient. The use of attribute sampling allows the evaluator to make

inferences about an entire population of transactions without actually testing each one of those transactions.

The requirement for using attribute sampling is, first, that the attribute being sampled be reducible to a simple binary expression. This requires that the characteristic can be thought of in terms of a "yes/no" or "1/0" model indicating presence or absence of the attribute. An example would be the presence or absence of an authorizing signature on a time and attendance card. The population must also be identifiable and accessible to the evaluator. This depends on management providing the necessary access to files and documents for evaluation of the attribute. The population must have a finite means of identifying individual population items so that a sample can be chosen by a random or systematic selection process. By means of statistical processes, the sample size required to make inferences about the population in question can be determined [Ref. 9:p. 424].

In tests of internal control, the attribute of interest is usually defined as a failure of a control to work effectively, or a control deviation. Examining the required sample for this attribute and identifying the rate of its occurrence in the sample permits a statistical estimate of its rate of occurrence in the entire population. Through the use of attribute sampling tables [Ref. 9:p. 428], the sample deviation rate can be converted to a population deviation rate at the desired risk level that the evaluator is willing to

accept for relying on the sample data. The advantage of this approach is that time and effort are saved by reducing the number of actual documents or population items which have to be examined to achieve a valid representation of the population under study [Ref. 11:p. 727-732]. Tests of the three transaction cycles follow, with a description of the procedural steps employed.

#### B. TESTS OF CASH RECEIPTS AND CONTROL

To test the cash receipts and control cycle the key controls were identified, the attributes which would represent the presence or absence of the control were defined, and the sampling unit required for examination was established. The sampling unit is simply the document or physical evidence which provides the information concerning the attribute in question. The key controls, related attributes, and sampling unit for the cash receipts and control cycle are as follows:

<u>Key Control</u>	<u>Sampling Unit</u>	<u>Attribute</u>
1. Receipt of change fund	Daily Cashier's Record	Cashier's signature
2. Total cash count	Daily Cashier's Record	Cashier's signature
3. Manager's receipt of cash	Daily Cashier's Record	Manager's or other authorized signature
4. Complete documentation	Daily Activity Report	Required documentation present



The Daily Cashier's Records and Daily Activity Reports for the NAFI are maintained for 90 days and are filed by date. The Daily Cashier's Reports are attached to the copy of the Daily Activity Report. There is no set number of Daily Cashier's Reports for any given day. Rather, it is a function of the total number of cash registers opened on a given day. To define the population, julian dates were assigned to each of the Daily Activity Reports for the period of December 1991 through February 1992. This resulted in a population which was identifiable by discreet integers from 335 through 365 and one through 60. For attributes which had a sampling unit of the Daily Cashier's Record, an associated Daily Activity Report was identified by random sampling and the attached Daily Cashier's Reports were tested.

Sample size was established by arbitrarily specifying the deviation rate which the evaluator would allow in the population and still consider the control to be effective [Ref. 9:p. 422]. For attributes 1, 3, and 4 above, the tolerable deviation rate (TDR) was established at 10 percent; and for attribute 3, TDR was set at 5 percent.

The next step was to specify the acceptable risk of overreliance (ARO), which is the risk the evaluator is willing to accept that the sample data and resulting inferences misstate the actual population deviation characteristics [Ref. 9:p. 422]. The ARO was set at 10 percent for attributes 1, 2, and 4, and was set at 5 percent for attribute 3. Lower

risk and tolerable deviation levels were used for attribute 3 because of the greater importance of this control relative to the other attributes being tested.

The last entering argument for determining sample size was the estimation of the population deviation rate (EPDR). EPDR is the evaluator's advance estimate of the percentage of deviations in the population [Ref. 9:p. 423]. Through random observation of the use of the Daily Cashier's Records and Daily Activity Reports, EPDR was set at zero for attributes 1, 2, and 3 and at 2 percent for attribute 4.

Utilizing an attribute sampling table [Ref. 9:p. 425], sample sizes were determined for the attributes of the cash receipt and control cycle. Attributes 1 and 2 resulted in sample sizes of 18 and attribute 3 resulted in a sample size of 36. For these three attributes the actual sampling unit was the Daily Cashier's Record. The samples of 18, 18, and 27 were selected from the Daily Activity Reports, and all of the attached Daily Cashier's Records were tested for the respective attribute. The samples thus became 18, 18, and 27 individual days' Cashier's Records. This resulted in 91 Daily Cashier's Records for attribute 1, 100 Daily Cashier's Records for attribute 2, and 191 Daily Cashier's Records for attribute 3. Statistically, a much larger than necessary number of documents was tested for these attributes, but selection of the Daily Cashier's Records was simplified by association with the related Daily Activity Reports. Attribute 4 resulted in

a sample size of 27, which only required sampling of the Daily Activity Report. The finite population correction factor was applied to achieve the final result for each attribute, to allow for the relatively large percentage of a small population being tested [Ref. 9:p. 426].

Samples were selected using a random number chart of 2,500 four-digit random numbers [Ref. 12:p. 589-593]. The selection was based on the last three digits in the random numbers and the start point was established by the "blind-stab" method. Once the appropriate quantity of random numbers was generated for attribute 1, calendar dates were assigned to the random julian date equivalents, and those Daily Activity Reports were selected and the attached Daily Cashier's Records were examined for deviations. This selection process was repeated for each of the other three attributes providing separate, distinct, random lists for each characteristic. Deviations were recorded and totalled for each attribute.

Deviations and sample size information were combined to convert the sample deviation results into inferences about the incidence of deviations in the population. A second attributes sampling table was used to determine a computed upper deviation rate (CUDR) for each attribute. CUDR is the highest expected percentage deviation rate in the population, given the risk of overreliance acceptable to the evaluator. [Ref. 9:p. 427-429]

The data for attributes 1 through 4 are summarized in Table 1.

TABLE 1  
CASH RECEIPT AND CONTROL ATTRIBUTE SAMPLING DATA

<u>Attribute</u>	<u>Sample Size</u>	<u>Deviations</u>	<u>ARO</u>	<u>CUDR</u>	<u>TDR</u>
1	91	3	10%	7.37%	10%
2	100	0	10%	2.30%	10%
3	191	0	5%	1.60%	5%
4	27	0	10%	8.24%	10%

The data indicate that, for the selected tolerable deviation rate and the selected acceptable risk of overreliance, that the populations represented by attributes 1 through 4 meet the requirements of the evaluation. This is necessarily so because TDR is greater than CUDR in each case. The implication is that the greatest deviation expected in the population is less than the deviation that is acceptable to the evaluator.

#### C. TESTS OF PAYROLL CYCLE CONTROLS

The tests of the payroll cycle for the NAFI centered on the Time and Attendance Report (DA Form 4850) and the Nonappropriated Fund Document Transmittal Form (DA Form 4853). Since the accounting for pay and preparation of checks is done by the CAO, the responsibility of the NAFI is concentrated on the preparation and timely submission of the Time and

Attendance Forms. The key controls, related attributes, and sampling unit for the payroll cycle are as follows:

<u>Key Control</u>	<u>Sampling Unit</u>	<u>Attribute</u>
1. Authorization of pay	Time and Attendance Report	Manager's or Assistant's signature
2. Complete Documentation	Transmittal document	Required documentation present

The time and attendance reports and the transmittal documents are retained at the NAFI for two past pay periods. Since 60 personnel are employed at the NAFI, this provided a population of 120 to test. The most important control was attribute 1 which is the authorization for each individual to receive pay for the hours which they worked. This authorization establishes the entitlement of employees to wages. The time and attendance reports are identifiable only by names or social security numbers of the individual employees. This made identification of population individuals difficult and complicated the method for selecting a random sample of population members. To circumvent this difficulty, the decision was made to examine the entire population given that the total population of 120 individuals was relatively easy to test.

Testing for attribute 1 resulted in no deviations. The population was first counted to ensure there were no missing



documents, given an employee count received from the manager. Specimen signatures were received from the manager and assistant manager and comparisons were made to the time and attendance reports. The manager had signed all reports in the previous two pay periods.

Attribute 2 required the time and attendance reports and the transmittal documents to be present to support documentation requirements. The transmittal documents for both previous pay periods were present along with the associated time and attendance reports.

#### D. TESTS OF INVENTORY RECEIPT AND CONTROL

The key controls in the inventory receipt and control cycle focused on the approval of purchase requests, receipt of inventory, and documentation of the ordering and receiving process. The key controls, related attributes, and sampling units for the cycle are these:

<u>Key Control</u>	<u>Sampling Unit</u>	<u>Attribute</u>
1. Purchase authorization	NAF Purchase Request	Manager's signature
2. Received inventory inspected	Receiving Report	Manager's signature
3. Complete Documentation	Purchase Order	Required documents present

The documentation for inventory receipt and control is filed by the NAFI in alphabetical order by vendor name and is



held for one year. The filed documents represent the orders that have been filled and for which purchase orders and receiving reports should exist. Copies of outstanding purchase requests, not yet filled, are maintained in a binder by the receiving clerk in alphabetical order. The entire population of outstanding requests were tested for attribute 1 with no deviations.

Since there was no readily unique identification for the filed population of filled orders, a count was made to establish a base for the sample starting point. Five hundred and twenty-five items were identified in the population. Systematic sampling was selected as a sampling technique, which requires the evaluator to determine a sampling interval based on the total population divided by the sample size [Ref. 11:p. 736]. This interval establishes which documents to select for testing. The starting point of the selection process is the result of a random number selected from a random number table using a "blind-stab" technique. Sample size is determined by selecting a desired ARO, TDR, and EPDR and entering the appropriate attributes sampling table [Ref. 9:p. 422-423]. The finite population correction factor was then applied to determine the minimum required sample size for inference to the population. Attributes 1 and 2 required samples of 53, which gave an interval of every ninth document (525/53). The starting point for attribute 1 was document number 6 and the starting point for attribute 2 was document

number 4. Attribute 3 required a sample of 47, which gave an interval of every eleventh document, and the random starting point was document number 1. The test data for attributes one 1 through 3 are presented in Table 2.

TABLE 2  
INVENTORY RECEIPT AND CONTROL ATTRIBUTE SAMPLING DATA

<u>Attribute</u>	<u>Sample Size</u>	<u>Deviations</u>	<u>ARO</u>	<u>CUDR</u>	<u>TDR</u>
1	53	3	5%	14.3%	5%
2	53	2	5%	11.7%	5%
3	47	3	10%	13.4%	10%

The test results for inventory receipt and control indicate that the controls are not effective in achieving the objectives of the key controls. In all three cases the computed upper deviation rate far exceeds the tolerable deviation rate established for the attributes. This lack of effective internal control should suggest to management that greater emphasis needs to be placed on this area to strengthen controls which could prevent inadvertent or intentional loss in inventory receipt and control.

For attribute 1, the three deviations consisted of three missing NAF Purchase Requests. So, no approval signature could be found for those purchases. Attribute 2 was the signature of the manager on the receiving report. Two deviations were found. One was a missing receiving report, which was considered a deviation. The second deviation was

the lack of a signature on the receiving report. The test for the third attribute, complete documentation of the cycle, had three sample deviations present. Two of these deviations were for missing receiving reports and the third deviation was for a missing NAF Purchase Request. The numbers of missing documents in the samples for all three attributes are evidence of the ineffectiveness of internal control in the area of complete documentation.

These deviations and their possible implications identify for management areas of opportunity for internal control system improvement. By utilizing information gained in the testing and evaluation phase, specific recommendations and conclusions for the cycles under study are drawn and are presented in Chapter V.

## **V. ANALYSIS, CONCLUSIONS, AND RECOMMENDATIONS**

### **A. INTRODUCTION**

The entire process of investigating and understanding the internal controls for the Fort Ord Golf Course has required the use of observation, interviews, operational manuals and regulations, and diagnostic tools. The tools that were utilized in the review were narrative descriptions, flowcharts, and internal control questionnaires. Use of these tools and the results of tests of controls provided a full understanding of the internal controls for the desired transaction cycles. The previous chapters have developed the principles and background for internal controls and have described investigative techniques to gain an understanding of the internal control structure as implemented by the golf course management. With the body of information gathered, an analysis of internal control effectiveness can be made for the transaction cycles examined in the study.

### **B. CASH RECEIPTS AND CONTROL ANALYSIS**

The cash receipts and control transaction cycle is well documented and effectively controlled. Each phase of the process from receipt of the change fund by the cashier to the deposit of the cash receipts is monitored and supervised to prevent loss or theft. The control questionnaire, located in

section B.3 of Chapter III, was answered in the affirmative for all questions except 14 and 27. Question 14 was not applicable because the NAFI does not maintain accounts receivable and does not receive payments by mail. Number 27 was answered in the negative, which implies a weakness in this area. The weakness uncovered by question 27 is the failure of management to authorize in writing those individuals who can close cash registers and receive the cash balances for the business day. A written authorization would reduce the number of individuals with the responsibility and potential culpability for handling these monies and would simplify the chain of custody for inquiries and errors. Observation showed that the individuals involved in the cash receipt transaction cycles were knowledgeable and competent in their duties. This was supported by the attribute sampling results, which revealed very few errors and computed upper deviation rates much smaller than the selected tolerable deviation rates. Considering the importance of the Daily Activity Report to the CAO, these results are reassuring. The results are also not unexpected because the Daily Activity Reports receive scrutiny on a continuous basis from the CAO, which serves as an external reviewer of cash receipts and control.

Observation did uncover one inconsistency in cash register operations. The error concerned a failure to inform a manager of an overring which was corrected by ringing up "no sale" for subsequent transactions to cover the overring. This could be



a failure to adequately train an individual or, more likely, the result of a required procedure which seemed cumbersome and inefficient to the cashier. Such shortcuts of control could lead to recriminations against the cashier if a surprise cash count is taken or the cashier has to close his/her register while a cash deficit remains.

Cash receipts are likely the most desirable item for the employee who would choose to be dishonest. The NAFI has adequate internal controls to prevent loss in this area and the controls are working effectively.

#### C. PAYROLL CYCLE ANALYSIS

The NAFI has a limited but important role to play in the payroll function. The key area for this transaction cycle is the time and attendance report, which is the basis for employees earnings. All internal control questions from the questionnaire in section C.3 of Chapter III were answered in the affirmative, with the exception of number 12. This question asks about the presence of written authorization for the distribution of paychecks for the NAFI. Although the payroll clerk has this responsibility, according to the manager and the payroll clerk, it is not written in internal control documents or standard operating procedures.

Tests of the documentation and authorizing signature on the time and attendance reports showed no deviations and is



considered to be in control. Two weaknesses, however, were observed in the payroll transaction cycle.

In regard to separation of duties, the payroll clerk has the responsibility for every key duty except the authorization of the time and attendance reports. Her duties include preparing timecards, transferring hours to the time and attendance reports, mailing the documents to the CAO, receiving the paychecks from RMD, distributing the paychecks, and disposing of undelivered checks. These responsibilities could likely be divided among other administrative personnel to reduce the responsibility of the one individual for the cycle and to gain greater control through shared responsibility.

A second area of weakness observed in the study was the distribution of paychecks. Supervisors receive paychecks for their divisions and become responsible for distribution within their divisions. No receipt signature is obtained from the supervisor, which eliminates a traceable chain of custody for the checks. A lost or undelivered check would be difficult to track because of the broken chain of custody.

Payroll controls are strong in the area of authorizing wages and ensuring all employees are paid. However, areas of custody and separation of duties need to be evaluated as to their impact on the internal control objectives of the NAFI.

#### **D. INVENTORY RECEIPT AND CONTROL ANALYSIS**

The inventory receipt and control cycle encompasses the entire process of requesting purchases and receiving services and inventory for resale and use. Although the NAFI is not responsible for the preparation of the actual purchase order, management is responsible for the purchase request which is used to prepare the subsequent purchase order. The NAFI also is responsible for the receipt and inspection of goods and for preparation of the receiving report, which is submitted to the CAO to trigger the payment of vendor invoices. All internal control questions were answered in the affirmative for the inventory receipt and control cycle, though weaknesses in implementation were shown by the testing of controls.

Areas of weakness appeared in all tests of key controls. Computed deviation rates were far in excess of tolerable rates. This leads to a conclusion that controls are ineffective in this area. The greatest and most consistent deviation was the lack of documentation for the attribute being investigated. This was exacerbated by the condition of the files for inventory receipt and control. The NAFI established a one year filing period for the documentation in the cycle, but the files contained purchase orders and attached documentation for three years. The old documents were included in the sampling scheme and most likely were responsible for some of the deviations, although deviation rates by years were not computed. Errors or deviations from

several years back may not be germane to the operation for today, though, because changes of personnel and minor changes in procedures could have reduced deviation rates in more current files. Additional testing of the most current files would be necessary to substantiate such a claim, however. The files for inventory receipt and control need to be purged and brought up to date in accordance with the one year retention plan.

The inventory receipt and control cycle was not operating effectively because the controls were not being implemented adequately. Turnover in personnel within the receiving and purchasing area of administration contributed to this problem and current procedures appear to be in conformance to control objectives, based on the outstanding purchase requests. This assumption could also be the result of a transaction cycle which is controlled in the early stages, but which is not adequately controlled in the latter stages. A second review of internal controls for this area, based on purged files, would be necessary to assess current effectiveness.

#### **E. RECOMMENDATIONS**

Recommendations for the NAFI follow closely the conclusion and analyses that were presented for each transection cycle. Five recommendations are offered for consideration by management.

## **1. Written Authorization**

Less verbal authorization and more written authorization is recommended in areas where transfer, receipt, and control of assets is required. The authority to close and receive cash receipts or the authority to disburse paychecks are examples where written authorization is appropriate. These measures assign responsibility to individuals designated by authority and prevent access by others.

## **2. Separation of Key Duties**

The area of payroll places virtually all key duties except authorization in the control of one individual. This not only places a burden on that individual but also places management in a position of reduced control of the transaction cycle. No suggestion is made that a trusted employee is not honest, but it is in the best interest of management to reduce areas which could be subject to errors or fraud brought about by weaknesses within the system.

## **3. Establish Chain of Custody**

The NAFI management would benefit in meeting internal control objectives by ensuring that assets which are subject to transfer or use are traceable through a chain of custody. The distribution of paychecks is an area for application of this measure. A chain of custody which requires a signature for transfer of responsibility protects against fraud and also aids in tracking an asset which is lost or misplaced.

#### 4. Purges Files

Old files which are not of any value to the NAFI should be purged. This would allow for a more efficient filing system that could be managed and controlled through use of implemented internal procedures. Purging old files would also facilitate the internal reviews performed by the NAFI or some other external agency.

#### 5. Cash Register Training

In view of incorrect procedures used by a cashier in a very small observation sample, it is possible that procedural training could enhance the operation of the cashiers and ensure closer conformance to internal control directives. Failure of cashiers to understand the procedures of internal control put them in jeopardy of surprise cash counts and cash deficits. The danger to the NAFI is that undetected procedural errors could degenerate into intentional acts of dishonesty and theft.

## APPENDIX

[illegible]



# DAILY ACTIVITY REPORT

ACTIVITY: FI ORD GOLF - G1

DATE:YYMMDD \_\_\_\_\_

PREPARED BY: \_\_\_\_\_

TRANS ID # \_\_\_\_\_

MANAGER: \_\_\_\_\_

JV CODE \_\_\_\_\_

CR \_\_\_\_\_

DESCRIPTION		D/C - CLAS	DR AMOUNT	CR AMOUNT
DEPOSIT BANK OF AMERICA	G1	D 10100		//////////
G/CLUB CHARGES		D 12100		//////////
BAR SALES		C 30101	//////////	
SHACK BAR SALES		C 30114	//////////	
I/S SALES		C 30112	//////////	
PRO SHOP SALES		C 30139	//////////	
PRO SHOP DISCOUNTS		D 30539		//////////
DAILY GREEN FEES		C 53141	//////////	
CLUB RENTAL / REPAIR		C 50439	//////////	
CART RENTAL		C 53341	//////////	
HAL-O-MATIC/DRIVING		C 53241	//////////	
EMPLOYEES DISCOUNT		D 30614		//////////
ADVANCE GREEN FEES 267.2		C 26720	//////////	
CASH SHORTAGE - BAR		D 73901		//////////
CASH SHORTAGE - SHACKBAR		D 73914		//////////
CASH SHORTAGE - PRO SHOP		D 73939		//////////
CASH OVERAGE - BAR		C 51101	//////////	
CASH OVERAGE - SHACKBAR		C 51114	//////////	
CASH OVERAGE - PRO SHOP		C 51139	//////////	
INSTRUCTION FEES		C 53441	//////////	
GIFT CERT. - SALES 740.2		C 24020	//////////	
GIFT CERT. - REDEEMED 240.2		D 24020		//////////
DEPOS.SPECIAL ORDER/EVENTS		C 20220	//////////	
REDEEMED DEPOSITS/SPEC.ORDERS		D 20220		//////////
USAGE FEE		C 50414	//////////	
RETURNED CHECKS/REDEPOSITS		C 12400	//////////	
OTHER				
		TOTALS	\$	\$

PARTY CONTRACT #: \_\_\_\_\_

RECEIPT NO: \_\_\_\_\_ to \_\_\_\_\_

OFFICERS CLUB CHARGES: \_\_\_\_\_

ADVANCED GREEN FEES: NORTH \_\_\_\_\_

ADV. LOCKER FEES: NORTH \_\_\_\_\_

# NONAPPROPRIATED FUNDS TIME AND ATTENDANCE REPORT (AR 23(4-6.5))

TOUR OF DUTY		REGULAR HOURS			OVERTIME			SUNDAY			HOLIDAY			LEAVE			INT			REMARKS
FROM	TO	DAY	CD	1st	2nd	3rd	1st	2nd	3rd	1st	2nd	3rd	1st	2nd	3rd	1st	2nd	3rd		
THU																				
FRI																				
SAT																				
SUN																				
MON																				
TUE																				
WED																				
FIRST WEEK TOTALS																				
THU																				
FRI																				
SAT																				
SUN																				
MON																				
TUE																				
WED																				
SECOND WEEK TOTALS																				
PAY PERIOD TOTAL																				
CORRECTIONS																				
1	3.4	6.3																		
2	23.2																			
D.C. - HOURS WORKED																				
D.C. - HOURS WORKED																				

CERTIFIED CORRECT AS TO ALL TIME WORKED AND LEAVE TAKEN THROUGH THE END OF THIS TIME PERIOD

SUPERVISOR'S SIGNATURE \_\_\_\_\_

DATE \_\_\_\_\_

PAY PERIOD \_\_\_\_\_

COPY 1 - SUBMIT TO PAYROLL OFFICE



TAR		TAR		TAR		TAR		TAR		TAR	
<b>ARMY NAJ PURCHASE REQUEST</b> For use of Bds form, see DA Pam 215-4, the procurement agency is DCSFEN				1. NAJ ADDRESS FORT ORD GOLF COURSE BLDG 4100, 1 PECLURE WAY FORT ORD, CA 93941				2. REQUEST NO.			
				TELEPHONE NUMBER (408)242-3988				3. DATE			
4. ITEMS BEING REQUESTED											
ITEM NO.		DESCRIPTION OF ITEM/SERVICE		QUANTITY		UNIT		EST UNIT PRICE		ESTIMATED AMOUNT	
a	b	c	d	e	f	g	h	i	j	k	l
5. REQUESTED DELIVERY DATE				6. DELIVER TO				7. SOLE SOURCE JUSTIFICATION ATTACHED			
				FORT ORD GOLF COURSE BLDG 4100, 1 PECLURE WAY FORT ORD, CA 93941							
8. REQUESTOR'S SIGNATURE AND PRINTED NAME						9. NAJ FIELD MANAGER'S SIGNATURE AND PRINTED NAME					
DOUGLAS C. PARKER PROFESSIONAL/MANAGER						WELDON E. KELLEY/ADCTA					
10. FUNDS ARE AVAILABLE IN THE AMOUNT OF \$						11. ACCOUNTING DATA					
12. TITLE OF CERTIFYING OFFICIAL						SIGNATURE					
LINDA A. MDRELLO, CHIEF, R&D, DCA											
13. REMARKS											
APPROVAL/DISAPPROVAL AND DATE (if applicable)											
14. INSTALLATION COMMANDER'S SIGNATURE AND PRINTED NAME						DATE					

MATERIAL INSPECTION AND RECEIVING REPORT		1. PRIC INSTRUMENT WHEN (CONTRACT#)		2. INSTRUMENT NO.		3. RECEIPT		4. PAGE 1 OF 1	
		NAFRI-		IR#				5. ACCEPTANCE POINT FI. ORD	
6. SHIPMENT NO.	7. DATE SHIPPED	8. RS TEN		9. DISCOUNT TERMS					
11. SHIPMENT ORIGIN		10. ADMINISTERED BY							
13. SHIPPED FROM (NAME-UNIT-RT)		12. PAYMENT WILL BE MADE BY							
15. SHIPPED TO		14. MARKED FOR							
				CENTRAL ACCOUNTING OFFICE P.O. BOX 6111 TEXARKANA, TX 75505-6111					
FORT ORD GOLF COURSE BULG. 4100, 1 ECLURE WAY FORT ORD, CA 93941									
16. ITEM NO.	17. STOCKPART NO. <small>(Indicate number of shipping containers, type of container, container number)</small>	18. DESCRIPTION	19. QUANTITY SHIP/REC'D	20. UNIT	21. UNIT PRICE	22. AMOUNT			
		SEE ATTACHED/	//////		//////				
PROCUREMENT QUALITY ASSURANCE						RECEIVER'S USE			
<input type="checkbox"/> POA <input type="checkbox"/> ACCEPTANCE of listed items has been made by me or under my supervision and they conform to contract, except as noted herein or on supporting documents.			<input type="checkbox"/> POA <input checked="" type="checkbox"/> ACCEPTANCE of listed items has been made by me or under my supervision and they conform to contract, except as noted herein or on supporting documents.			Quantities shown in column 17 were received in apparent good condition except as noted.			
DATE _____ SIGNATURE OF ARMY GOVT REP _____			DATE _____ SIGNATURE OF ARMY GOVT REP _____ DOUGLAS C. PARKER PRO/MANAGER			DATE RECEIVED _____ SIGNATURE OF ARMY GOVT REP _____ TYPED NAME DOUGLAS C. PARKER PRINT OFFICE FI. ORD GOLF COURSE			
TYPED NAME _____ PRINT OFFICE _____			TYPED NAME _____ PRINT OFFICE _____			If quantity received by the Government is the same as quantity shipped, indicate by (✓) mark. If different, enter actual quantity received below quantity shipped and enclose			
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